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SOME ASPECTS OF THE LAW RELATING TO THE TAXATION OF PARTNERSHIPS

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SOME ASPECTS OF THE LAW RELATING TO THE TAXATION OF PARTNERSHIPS

A. INTRODUCTION

1. This paper is intended to be limited both in size and in the topics dealt with. It is therefore proper to set out at the beginning what it is intended to cover. It will be divided into two parts. The first will discuss specific provisions of the Land and Income Tax Act 1954. All sections mentioned in this paper will refer to that Act unless otherwise stated. The second part will discuss briefly some of the principles of partnership law and their implications or consequences when applied to the field of taxation.

2. It is not intended to deal with such topics as tax avoidance and alienation of income both of which have considerable relevance in the partnership field. Both are major topics which would justify research papers in their own right. Some specific issues within those topics may be discussed but their will be no attempt to deal with either topic as a whole.

3. Nor is it proposed to deal with areas where the principles of taxation law applicable to partnerships do not differ significantly, if at all, from those applied to taxpayers not in partnerships. Thus many cases in the

various taxation law reports deal with issues involving deductions but many of those issues apply equally well to joint venturers and sole traders.

4. Even after removing from consideration those matters referred to in the last two paragraphs, there remains much of interest in the field of taxation of partnerships.

B. SPECIFIC PROVISIONS OF THE LAND AND INCOME TAX ACT 1954

Section 10

5. Section 10(1) deals with the filing of income tax returns by those who derive income jointly. Section 10(1)(b) provides that in the case of partners, they must file a joint return showing the amount of the income jointly derived and the respective shares of each partner. Each partner must also make a separate return of all his other income not included in the partnership return. The partnership as such is not a recognised taxable entity.

6. Nowhere in the Act is "partner" or "partnership" defined and recourse must be had to partnership law to determine whether or not a business relationship constitutes a partnership. This is by no means an easy question to answer. In section 4 of the Partnership Act 1908

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partnership is defined as:

> "the relation which subsists between persons carrying on a business in common with a view to profit..."

but does not include companies under the Companies Act. Section 5 of the Partnership Act gives rules for determining the existence of a partnership. Joint or part ownership of property does not of itself create a partnership even if profits from the property are shared. The sharing of gross returns does not create a partnership. The mere receipt of a share of profits from a business does not of itself make the recipient a partner but it is prima facie evidence of a partnership. Subsection 5(c) contains the following additional rules:

> "(i) The receipt by a person of a debt or other liquidated amount, by instalments or otherwise, out of the accruing profits of a business does not of itself make him a partner in the business or liable as such:
>
> (ii) A contract for the remuneration of a servant or agent in a business by a share of the profits of the business does not of itself make the servant or agent a partner in the business or liable as such:
>
> (iii) A person being the widow or child of a deceased partner, and receiving by way of annuity a portion of the profits made in the business in which the deceased person was a partner, is not by reason only of such receipt a partner in the business or liable as such:
>
> (iv) The advance of money by way of loan to a person engaged or about to engage in any business on a contract with that person that the lender shall receive a rate of interest varying with

"the profits, or shall receive a share of the profits arising from carrying on the business, does not of itself make the lender a partner with the person or persons carrying on the business, or liable as such:

Provided that the contract is in writing, and signed by or on behalf of all the parties thereto:

(v) A person receiving by way of annuity or otherwise a portion of the profits of the business in consideration of the sale by him of the goodwill of the business is not, by reason only of such receipt, a partner in the business or liable as such."

7. It will be observed that the foregoing rules do not give any positive guidance as to what constitutes a partnership but merely indicate what is insufficient to do so. Recourse must therefore be had to the common law. In Commissioners of Inland Revenue v. Williamson [1] the Lord President Lord Clyde said:

> "The only proof that a partnership exists is proof of the relations of agency and community in losses and profits and of the sharing in one form or another of the capital of the concern..."

The mere fact that parties claim to be partners or claim to have negated partnership is not conclusive. What is important is what was done by the parties and with what intention. If parties enter a partnership agreement but carry on business as though no partnership had been constituted, then the agreement itself will be ineffectual

(1928) 14 T.C. 335, 339

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and no partnership will have been created.[2] On the other hand partnerships can exist without the partnership agreement having been reduced to writing.

8. There are two provisions of the Land and Income Tax Act which, in certain circumstances, impose additional requirements before a partnership will be recognised for tax purposes. One is section 10(2) and the other is section 106.

9. Section 10(2) provides:

> "For the purposes of this Act a husband and wife carrying on business together shall not be deemed to be carrying on business as partners, unless in fact they are carrying on business under a deed of partnership."

10. The terms of the provision are not entirely satisfactory from the Commissioner's point of view. The words "shall not be deemed" could indicate that the provision relates only to arrangements which are not actually partnerships but which might be deemed to be partnerships for the purposes of the Act. A better wording from the Commissioner's point of view would have been to replace "shall not be deemed" with "shall be deemed not". Nevertheless, for similar reasons as those which prevailed in <u>Commissioner of Inland Revenue</u> v. <u>Lilburn</u> [3], which dealt with section 106 and which is

SEE "<u>SIMON'S INCOME TAX</u>" (2ND EDN, VOL I (REPLACEMENT 1964-1965)) PAGE 379, PARAGRAPH 1009 ET SEQ.; ALSO <u>COMMISSIONERS OF INLAND REVENUE</u> V. <u>WILLIAMSON</u> (SUPRA NOTE 1)

1960 N.Z.L.R. 1169; POST PARAGRAPH 22

discussed below, it is perhaps unlikely that the courts would permit taxpayers to rely on this defect. What is more likely is that it would be held that "deemed" is here used not in the sense of imposing upon a term an artificial construction but rather of putting beyond doubt a particular construction which would otherwise be uncertain. It is of course clear that the intention of the provision is to impose a requirement of a deed on husband-wife partnerships before they are recognised for tax purposes. The purpose appears to be the avoidance of difficult factual questions as to the existence of such partnerships. The courts will probably give effect to this intention but there remains an element of doubt.

11. In (1967) 3 N.Z.T.B.R. Case 27 a tax inspector had investigated the affairs of a market gardener and had found that there were considerable deficiencies in the income returned. The taxpayer did not challenge the amount of the income found by the inspector but he claimed that he had been carrying on the business in partnership with his wife. There was no partnership deed nor any other partnership agreement. No partnership accounts had been kept and no partnership returns had been filed. The wife could give no account of how the money supposedly paid to her had been disposed of. The Board was invited (inter alia)

to recognise the existence of the partnership notwithstanding the non-compliance with section 10(2). Although the Board decided there was no way the taxpayer could extricate himself from the difficulties imposed by section 10(2) they went on to consider whether there were any other grounds for upholding the existence of the partnership. They eventually held that the taxpayer had not proved the existence of a partnership but it is interesting that the Board went on to consider the question at all. There was, however, no mention of any difficulty with the wording of section 10(2). The Board was also asked to recognise that there had been a sharing of profits even if there was no partnership. The Board was not quoted any authority for this course. In any event, the wife had not filed separate returns and there was insufficient evidence that she had jointly derived the profits.

12. Although the decision, not surprisingly, went against the taxpayer, the case does highlight one aspect which ought not to be overlooked. Although a partnership may not exist, or may be not recognised for tax purposes, it does not inevitably follow that the income in question must have been derived only by one person. Section 10(1)(c) envisages income being derived jointly by persons other than co-trustees or partners. In such a case each

persom merely includes his share in his own return and it is assessed accordingly. No joint return is filed. If the income was derived by only one person, then the sharing of it with another will be merely an application of the income and will not affect the position of the taxpayer for tax purposes.

13. In Cunningham and Thompson's "<u>Taxation Laws of New Zealand</u>" Volume 2 paragraph 2166 it is pointed out that the rule laid down in section 10(2) is modified in practice. An opinion has been given to the Commissioner which indicates that in the absence of any deed of partnership between a husband and wife he is not at liberty simply to assess the whole of the income to the husband, if the wife has invested capital sufficient to warrant a share of income from the venture equal to that received from the unrecognised partnership. Consequently in those cases where capital is a significant factor in the earning of partnership income, the Commissioner will not enquire whether or not a deed exists if he is satisfied that the capital invested by the wife from her own savings bears at least the same proportion of the total capital as does her share of the profits to the total profits. However if personal services are the dominant factor in the earning of partnership income, the Commissioner will insist upon a deed of partnership.

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14. Two Australian cases where it was held that although the partnership had either not been proved or was not recognised for tax purposes the Commissioner should not arbitrarily reallocate for tax purposes the income derived by the wife are <u>1 C.T.B.R. Case 46</u> and <u>6 C.T.B.R. Case 57</u>.

<u>Section 106</u>

15. This is the other provision, apart from section 10(2), which imposes an additional requirement in certain circumstances before a partnership is recognised for tax purposes. The section deals with the position of relatives in businesses for tax purposes, whether as partners or employees. The section is here discussed only insofar as it deals with partnerships. A definition of "relative" for the purposes of the Act is given in section 2.

16. Subsection (1)(b) provides that if either a relative of the taxpayer is employed or engaged in the partnership business, or a company is a partner and a relative of a director or shareholder is employed or engaged in the partnership business, or if a taxpayer's partner is a relative or is a company whose director or shareholder is a relative, or if a taxpayer being a company has as a partner a relative of a director or shareholder,

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then the Commissioner, if he thinks that the remuneration or share of profits of any such relative is excessive having regard to

> "the nature and extent of the services rendered, the value of the contributions made by the respective partners by way of services or capital or otherwise, and any other relevant matters..."

he may reallocate the profits or income of the business among the partners in such shares as he considers reasonable. The amounts so allocated are deemed to be the incomes respectively derived by those persons from the business for the purposes of income tax.

17. In (1962) 1 N.Z.T.B.R. Case 37 A and his wife B had entered into a partnership agreement to carry on a dairy farming business. The partnership agreement was terminable at any time on one month's notice and consequently section 106 applied by virtue of section 106(6)(c) which is discussed below. B's father sold A and B a farm on very favourable terms but stipulated that B must receive one-third of the profits from the farm. On their income tax return the partners showed an allocation of two-thirds to A and one-third to B. The Commissioner reallocated £250 to B and the balance to A. The taxpayers objected claiming that the favourable terms on the purchase of the farm constituted a contribution by B

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otherwise than by way of services or capital within the meaning of section 106(1). The Board of Review agreed that the benefit to the partnership of the advantageous terms on the purchase had accrued because of B's relationship to her father and this was a contribution by her to the partnership. The Commissioner should have taken this into account as an "other relevant matter".

18. In (1963) 2 N.Z.T.B.R. Case 6 it was made clear that the onus is on the taxpayer to prove that a reallocation by the Commissioner was unreasonable. A and B carried on a manufacturing business in New Zealand as partners. Both were resident in Australia and the business was conducted by a manager. The partnership was dissolved and a new partnership formed in which the partners were A, B, A as trustee for some of his children, B as trustee for some of his children, and B and his wife as trustees for other of their children. When the Commissioner discovered that A and B were brothers he applied section 106(1) and reallocated the whole of the partnership income to them to the exclusion of the trusts. The taxpayers objected. The Board held that insufficient evidence had been given as to the contributions of the partners. They were confronted by a situation in which various persons, related by family ties and by associations in business, may or may not have contributed in various ways and in various

degrees to the partnership. As the evidence was unsatisfactory the appellants had failed to discharge their onus of proving that the the Commissioner had been in error in his reallocation.

19. In a number of cases the Board has made it clear that a formula for the division of profits in family partnerships which is found to be reasonable in one case will not necessarily be appropriate in another. Each case must stand on its own facts. Examples of such cases are (1964) 2 N.Z.T.B.R. Case 12, (1964) 2 N.Z.T.B.R. Case 35, (1971) 5 N.Z.T.B.R. Case 19 and Robertson v. Commissioner of Inland Revenue.[4]

20. Section 106(6) provides that:

> "This section shall not apply to a bona fide contract of employment or to a bona fide contract of partnership. For the purposes of this section a contract of employment or a contract of partnership shall be deemed to be bona fide if it complies with the following conditions..."

The subsection then lists five conditions which are discussed below. The wording of the part of subsection (6) above-quoted has given rise to an argument that the conditions do not give an exhaustive definition of "bona fide partnership" for the purposes of section 106 but merely set forth circumstances where a contract may be deemed to be bona fide. If that were accepted, it would be possible to exclude the operation of the section

[4] 1964 N.Z.L.R. 484; POST PARAGRAPH 33

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merely by showing that the contract was bona fide in the common law sense of the term irrespective of whether the five conditions were satisfied. The argument has, however, been firmly rejected by the courts in two cases.

21. In Moore v. Commissioner of Inland Revenue[5] McCarthy J. said that the use of the word "deemed" did not necessarily mean that the class was confined to the things deemed to be of the class but that the word could have that exhaustive connotation. That depends upon the whole language of the provision under review. He pointed out that subsection (6) was introduced as an amendment to what was then section 16 of the Income Tax Assessment Act 1951. There was no animosity between it and subsections (1) to (5) and it could not be argued that it was introducing something which would not otherwise be within the class "bona fide contract". He concluded that the five conditions were essential requirements before a contract could be considered bona fide for the purposes of the section.

22. In Commissioner of Inland Revenue v. Lilburn[6] the same question was considered in relation to a contract of employment. The decision, which was one of the Court of Appeal, has equal application to partnership agreements.

1959 N.Z.L.R. 1046

1960 N.Z.L.R. 1169

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The Court agreed with the decision in Moore's case (supra). McGregor J., giving judgment, said that much of the difficulty in the case had arisen from the unfortunate use in subsection (6) of the word "deemed". The word might be used in a number of ways:

(1) to impose upon a term an artificial construction which it would not otherwise bear, or

(2) to put beyond doubt a particular construction that would otherwise be uncertain, or

(3) to give a comprehensive description which includes what is obvious, what is uncertain and what is in the ordinary sense impossible.

Here the history of the provision showed that its intention was to remove from the court the duty of determining whether a contract was "bona fide" within the ordinary common law meaning of the term. This was not a case where "deemed" was used in the sense of deeming something to be that which it is not. A contract which complied with the five conditions could not help but be bona fide within the common law understanding of the term. Accordingly it was clear that subsection (6) was intended to enumerate the conditions required before a contract would be considered to be bona fide for the purposes of section 106. The five conditions therefore constitute an exhaustive definition.

23. It is submitted that on the basis of the history of the legislation and the intent of the legislature shown thereby, the above decisions were correct but one can only agree with McGregor J. that the use of "deemed" was unfortunate.

24. The first condition of subsection (6) is:

> "(a) The contract is in writing or by deed signed by all the parties thereto:"

It will be recalled that under section 10(2) a husband-wife partnership will require a deed.

25. Condition (b) is:

> "No partner and no person employed or engaged under the contract was under the age of 20 years at the date on which the contract was signed".

In <u>Moore</u> v. <u>Commissioner of Inland Revenue</u>[7] it was contended that the words "employed or engaged" related not only to "person" but also to "partner". Accordingly a firm could have partners below the requisite age and still satisfy the condition so long as they were not employed or engaged under the partnership contract. This argument was rejected. It was held by McCarthy J. that the subsection dealt with both partnership agreements and contracts of employment. The words "no partner" related to the former whereas "no person employed or engaged under the contract" related to the latter.

1959 N.Z.L.R. 1046

26. It would be a strange condition that allows a partnership agreement as bona fide if the infabt partners are sleeping partners but not if they are actively engaged in the business.

27. Condition (c) is:

> "The contract is binding on the parties thereto for a term of not less than 3 years and is not capable of being terminated by any party thereto before the expiry of that term except for the reasons specified in sections 36 and 38 of the Partnership Act 1908".

The grounds in section 36 of the Partnership Act are the death or bankruptcy of any partner, or if any partner allows his share of the partnership property to be charged in respect of his separate debt. Section 38 of the Partnership Act provides the following grounds upon which the Court can order the dissolution of a partnership:

> "(a)Where a partner is found lunatic by inquisition, or is shown to the satisfaction of the Court to be of permanently uhsound mind...:
>
> (b)Where a partner ... becomes in any other way permanently incapable of performing his part of the partnership contract:
>
> (c)Where a partner ... has been guilty of such conduct as ... is calculated to prejudicially affect the carrying on of the business:
>
> (d)Where a partner ... wilfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable ... to carry on the partnership business with him:
>
> (e)Where the business of the partnership can only

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(f) Where circumstances have arisen which ... render it just and equitable that the partnership be dissolved."

28. In (1969) 4 N.Z.T.B.R. Case 30 [7A] the partnership deed in question provided that the duration of the partnership should be for "five years from 1st January, 1966 and for such further or other period as the partners may mutually agree upon." The Commissioner contended that the words "and for such ... mutually agreed upon" rendered the partnership capable of being determined before the expiry of the minimum period specified in condition (c) of section 106(6). It was found to be unnecessary to decide this issue but the case serves as a warning that the term of the partnership deed or agreement, in the case of family partnerships, should be carefully worded. It is submitted that had the term read "...five years from ... ... and thereafter for such..." there could have been no argument that condition (c) had not been satisfied.

29. Condition (d) is:

"Each party to the contract has real and effective control of the remuneration, salary, share of profits, or other income to which he is entitled under the contract:"

This condition is comparable with section 94 of Australia's Income Tax Assessment Act. It should be noted that that provision has been amended since the decision in Robert

A. SEE FURTHER POST PARAGRAPH 35

Coldstream Partnership v. Federal Commissioner of Taxation.[8] As the section stood when that case was decided, the Australian provision required not only that a partner should not have the real and effective control and disposal of his share of the income, but also that such control and disposal should be held by another partner. In that case, which is the best known case on section 94, it was held that the first requirement had been established but the second had not. This was because the control and disposal of the shares in question were held to be controlled under the partnership agreement and the dominant partner was bound by its terms which prevented him from disposing of the other partners' shares as he might wish. The partnership agreement in the Robert Coldstream Partnership case would clearly fail to satisfy condition (d) of section 106(6).

30. A.P. Molloy in his book on estate planning[9] notes that the Australian Federal Commissioner has set out his policy on the amended section 94.[10] This Molloy claims is a useful guide to New Zealand's condition (d). The Federal Commissioner's view is that there is a lack of real and effective control if either

(1) the partnership agreement embodies provisions which

(1943) 68 C.L.R. 391 REVERSING 10 C.T.B.R. CASE 109

A.P. MOLLOY, "MOLLOY ON ESTATE PLANNING" (1ST EDN, BUTTERWORTHS 1970) SEE PAGE 45

SEE BOCK & MANNIX 3 AUSTRALIAN INCOME TAX LAW AND PRACTICE 3102

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prevent a partner from dealing with his share of the income in whatever manner he pleases, or

(2) where the conduct or control of the partnership is such that any partner is compelled to allow his share to be dealt with in a particular way and is unable to deal with it entirely as he pleases.

So care must be taken with any restrictive provisions in a partnership agreement designed to impose control over partners if section 106 will apply. The Federal Commissioner indicated that neither the mere voluntary leaving of profits in the business, nor the exercise of management functions by one partner, will be regarded as of itself entailing that the partner lacks real and effective control.

31. While the foregoing is, it is submitted, of some interest, the application in New Zealand of condition (d) will not be apparent until the Commissioner makes a similar pronouncement or until there are some New Zealand cases in point. To date these appear to be lacking.

32. Two Australian cases which are helpful are 10 C.T.B.R. Case 105 and 10 C.T.B.R. Case 106. There it was held that a joint owner of an asset could not be said not to have control of his or her share of the proceeds of that asset unless the joint ownership of the asset could itself be successfully challenged.

33. Condition (e) is:

> "The remuneration, salary, share of profits, or other income payable to a relative, or to a company a director or shareholder of which is a relative, is not of such an amount that the transaction constitutes in whole or in part a gift for the purposes of the Estate and Gift Duties Act 1968."

In <u>Robertson</u> v. <u>Commissioner of Inland Revenue</u> [11] it was argued that "gift for the purposes of the Estate and Gift Duties Act" meant "dutiable gift" so that exemptions from gift duty for gifts below a certain amount in any one year should be taken into consideration. This argument was rejected by Hardie Boys J. "Gift" and "dutiable gift" are separately defined in the Estate and Gift Duties Act. The Court's task where condition (e) is in issue is to look at the transaction in question and ascertain whether what the relative receives is of such amount that either in whole or in part inadequate consideration in money or money's worth has been given for it. That case involved a husband-wife partnership. The husband worked on partnership business almost four times as long as his wife and in much more trying conditions. He had contributed between four and five times the capital as had his wife. Nevertheless profits were shared equally subject only to a priority payment of £3 per week to the husband. It was held that the wife had given adequate consideration

11. 1964 N.Z.L.R. 484

when it was taken into account:

(1) that she had to bear all losses equally including capital losses so that she could more easily than her husband lose the whole of her capital contribution, and

(2)That she had to bear from her income half of the family's domestic expenses.

The fact that a similar result concerning the domestic expenses could have been achieved by the husband retaining a greater share of the income and paying the domestic expenses himself made no difference. It did not make it a mere application of his income. Merely because a result could have been achieved by a gift did not mean that because the result had been achieved a gift must have been made.

34. It was emphasised by Hardie Boys J. that this was an area where each case depends upon its own facts and he was not laying down a formula which could be applied in other cases. He took particular note of the fact that the partnership income was limited by the nature of the business, and accordingly the wife would not receive excessive amounts under the agreement.

35. An interesting case on section 106(6) is <u>(1969) 4 N.Z.T.B.R. Case 30</u> which is also discussed above.[12] There it was held that it was unnecessary to decide

12. ANTE PARAGRAPH 28

whether condition (c) applied as they concluded that the allocation made by the partners had been reasonable and should not have been disturbed by the Commissioner. At page 339, the Board found that whether or not condition (c) was satisfied, the question of whether or not the allocation should be disturbed would depend on condition (e). If there was no element of gift within the meaning of that condition then there was no reason to disturb the allocation even if the partnership was technically not bona fide as a result of the non-satisfaction of condition (c). From the other point of view, in any case where the Commissioner is justified in exercising his power under section 106(1) it can only be because a partner or employee has been favoured in some way which would make the contract of partnership in breach of condition (e).

36. The same reasoning appears to apply in the case of conditions (a), (b) and (d). If for example one partner is below the age of twenty, the result is only that subsection (6) does not apply so that section 106(1) does apply. But the Commissioner must still be able to conclude that the partner who is a relative has received an excessive share of the profits.

37. Other cases involving condition (e) include <u>(1968) 4 N.Z.T.B.R. Case 18</u>, <u>(1971) 5 N.Z.T.B.R. Case 18</u>

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and (1971) 5 N.Z.T.B.R. Case 19. The cases make it clear that each case depends on its own facts and each of these cases is mainly concerned with its own fact situation.

Section 101(2A)

38. Section 101 deals with income derived from the disposal of trading stock. The consideration for any trading stock sold together with other assets of the business is separately ascertained and assessed as income to the vendor. In Rose v. Federal Commissioner of Taxation[13] it was held concerning a similar Australian provision which related to assets "disposed of by sale or otherwise howsoever" that the constitution of a partnership consisting of a man who had formerly traded as a sole trader and his two sons in order to rum the business as a partnership did not involve a disposition by sale or otherwise of the assets of the business. All that the sole trader alienated to his two sons was an equal undivided one-third share each in the business as a whole. There could not be said to have been a disposal to the partnership of the whole property as the partnership was not a separate legal entity.

39. Section 101(2A) provides that section 101 with the necessary modifications applies where a share or interest in trading stock is sold or otherwise disposed of together

13. (1951) 5 A.I.T.R. 197

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with other assets of the business or with a share or interest in other assets of the business. Although the new subsection was not added until 1966 it seems clear that its purpose is to abrogate the decision in Rose's case (supra)

Section 102 (1A)

40. Section 102 deals with the sale of trading stock for inadequate consideration. Subsection (1A) was inserted in 1966 and corresponds to subsection (2A) of section 101. The same comments apply as for that provision.

Section 98(7)

41. Section 98 deals with the valuation of trading stock including livestock. The last sentence of subsection (7) was added in 1966 and appears to be for the same reasons as section 101(2A).

Section 117(6)

42. Section 117 deals with the sale of assets in respect of which depreciation has been allowed as a deduction for tax purposes. Where the sale price exceeds the depreciated value, the difference may be assessed to the vendor as income. Subsection (6), which was added in 1959, is

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almost certainly intended to abrogate the decision in <u>Rose's case</u> (supra). It provides:

> "(6) The foregoing provisions of this section shall, as far as they are applicabble and with the necessary modifications, apply in any case where, for any reason, including -
> (a) the formation or dissolution of a partnership; or
> (b) a variation in the constitution of a partnership, or in the interests of the partners,- a taxpayer sells or otherwise disposes of a share or interest in any property or a change has occurred in the ownership of, or in the share or interest of a taxpayer in, any property and any of those provisions would apply if the taxpayer had been the sole owner of the property."

<u>Section 129CE</u>

43. This section was added by the Amendment Act of 1971 and is a special provision dealing with the deductibility of losses incurred by misappropriations by partners other than the taxpayer or his spouse. The misappropriation must be of property which is

(1) received in the course of business by the partnership,

(2) not owned by any of the partners or their spouses.

The deduction is in respect of a payment which is

(1) made by the taxpayer to make good any loss suffered as a result of the misappropriation

(2) pursuant to a legal liability on the taxpayer to make good the loss

(3) not recouped by the taxpayer whether by way of insurance, indemnity or otherwise.

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Section 192

44. This provides that where a person in New Zealand has as a partner an "absentee" (as defined in section 173), the New Zealand partner is, for the purposes of the Act, the agent of the absentee in respect of his share of the income of the business. He must accordingly make returns on the absentee's behalf and is assessable and liable for the absentee's income tax.

C. PRINCIPLES OF PARTNERSHIP LAW AND THEIR APPLICATION IN THE FIELD OF TAXATION OF PARTNERSHIPS

45. It is proposed to discuss only a few of the princ--iples involved but these give good examples of the attention which must be given to the principles of partnership law when dealing with the taxation of partnerships.

Commencement and Dissolution of the Partnership

46. On a number of occasions persons entering upon a partnership agreement provide in it that the partnership shall be deemed to have commenced at some earlier date. It will be recalled from the discussion in paragraph 7 of this paper that merely stating that a partnership has been created is insufficient. It is necessary that the partnership actually operate as such. The most common

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situation where commencement of a partnership is purported to be back-dated is where the partners back-date the agreement to the commencement of the fiscal year. Cases such as <u>10 C.T.B.R. Case 111</u> (where the taxpayer lost) and <u>15 C.T.B.R. Case 67</u> (where the taxpayer won) show that the back-dating will have no effect unless other evidence is available that the partners were in fact operating as such at the purported date of commencement.

47. Similar considerations apply to the dissolution of a partnership. In <u>Federal Commissioner of Taxation</u> v. <u>Happ</u> [14] the partners of a firm entered into an agreement for dissolution on 22nd December, 1944. The agreement provided that the date of dissolution was 30th June, 1944. The business was carried on by two of the four former partners. The retiring partners had indicated that they did not wish to receive any share of the profits between 30th June and 22nd December. When filing the partnership income tax return, one of the continuing partners showed allocations of income to the two partners who had retired, up to the 22nd December. They were accordingly assessed on this income. They objected. The High Court of Australia (Williams J) upheld the Commissioner. Partnership law did not recognise any back-dating of the date of dissolution.

14. (1952) 5 A.I.T.R. 290

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Income had been derived by the firm up until 22nd December. The firm was not distinguishable from its members. The assessable income of the firm belonged to the members individually including the appellant. Accordingly the appellant derived his share of the income for the period in question and the fact that he elected not to receive it was irrelevant for income tax purposes.

48. Where a partnership decides to sell its stock preparatory to dissolution it will generally be held to be trading and not realising its assets.[15] The fact that an agreement for dissolution has been entered into may well be irrelevant.

Shares in a Partnership

49. Perhaps the best examples of taxpayers failing to come to grips with the ramifications of partnership law are to be found in the field of dealimgs with shares in partnerships. Bolton v. Federal Commissioner of Taxation[16] is a case in point. A firm of accountants entered into a complex set of transactions at the conclusion of which the partners held the same numbers of shares as before but some of the shares were purported to be held in trust. Different partners were holding shares in trust for each other. The Commissioner

15. SEE J. & R. O'KANE V. INLAND REVENUE COMMISSIONERS (1920) 12 T.C. 303

16. (1964) 9 A.I.T.R. 385

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<u>Derivation of Income</u>

50. In <u>Peterson</u> v. <u>Federal Commissioner of Taxation</u>[17] Windeyer J. said:

> "The date at which the profits of a partnership business are to be taken to have accrued depends upon the date at which they were ascertained and declared, or ought according to the partnership agreement or course of business to have been ascertained."

17. (1960) 106 C.L.R. 395, 405

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51. If this view is correct it presents exciting possibilities to those setting up a partnership for the first time. If the partnership agreement provides that profits are to be ascertained and declared only at ten yearly intervals or even longer periods, substantial postponements of income tax could be achieved. Where a firm is set up in this way from the beginning, the Commissioner would have difficulty in applying section 108 as after the annihilation there would be no prior status quo to which to return.

52. One question which immediately arises is what effect does section 92(1) have in this situation. It might well be argued that if income of the partnership is accumulated within the firm then this is being done "in his interest or on his behalf" within the meaning of that provision.

53. Windeyer J. did not follow through the possibilities of his statement and the matter appears to have been first raised by R.W. Parsons and G. Kenneally in a University of Sydney publication "<u>Principles of Income Tax Law in Australia</u>" Ch. XII. Obviously the possibility must wait until some courageous group tries it out and the Commissioner challenges the arrangement.

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54. In this writer's view however it is unlikely that an argument based on the Windeyer dictum would prevail. While it is certainly true that the Commissioner must take partnership law as he finds it with whatever consequences it may be doubted whether individual members of a firm do not derive their profits within the meaning of section 77 before an account is taken. The hypothetical result suggested in paragraph 51 borders on the absurd and it is submitted that only a very clear principle of the law of partnership could justify such a result. The Windeyer dictum appears to be much more doubtful than that.

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